Forbes Magazine Portfolio Strategy columnist and Fisher Investments chief executive Ken Fisher says the secret to successful stock selection is to invert the Footsie's trailing price/earnings ratio into an earnings/price ratio or earnings yield and compare it to 10-year gilts

Turn an idea on its head

I give you herein a trick, a secret and a rule. The trick? Whatever someone claims about Britain's stockmarket, if it is true, it must also be approximately true in major developed overseas markets. Suppose someone says "X" causes "Y" and your sense of British market history seems to confirm it. To ensure it isn't just a coincidental fluke, which happens, check if "X" and "Y" have a high correlation in the US, France, Germany, Italy, Japan and Spain. If so, OK. If not, it's bunk.

THE RULE? WHEN STOCKS ARE APPEALINGLY-PRICED BUT PEOPLE THINK THEY'RE APPALLINGLY-PRICED THEY ARE ACTUALLY APPALLINGLY APPEALING.

The secret? Stocks are cheap. Finance theory says we should demand a higher future flow from earnings from owning stocks – relative to cost as a yield – than we could get from safer fixed income flows or we should prefer the fixed income. But if you invert the Footsie's trailing price/earnings ratio into an earnings/price ratio or earnings yield and compare it to 10-year gilts, in most of history the earnings/price ratio has been lower than bond rates.

For example, from 1983 to 2002 the earnings/price ratio was always less than what bonds would pay yet most of that time stocks did fabulously. Defies logic? No. Subsequent earnings growth has been enough to make the future average earnings yield exceed the starting bond yield – from any period. Take 1984, with an 8% earning yield and 12% 10-year gilt yield. The next 10 years' earnings flows, from 1984 to 1994, would have averaged 14% despite not starting higher. In my career, contemporary British earnings yields have only exceeded gilts in 1974, 1981/82 – and, amazingly, now.

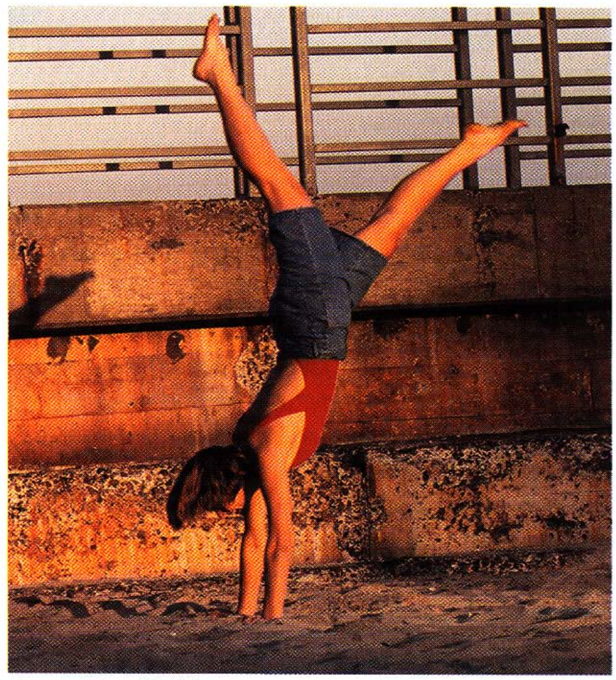
That said, today's bird in the hand does not require much growth expectation for stocks to compel. Stocks seem cheap. Is it true? Apply my trick. Look overseas, which confirms it is true. All major global markets have earnings yields exceeding their bond rates – for the first time in a very long time. Stocks are cheap. And just when conventional wisdom says they aren't.

The rule? When stocks are appealingly-priced but people think they're appallingly-priced they are actually appallingly appealing. Here are four appealing stocks with high, competitive current earnings yields.

Cendant in the US was a scandal stock before scandal stocks were common. Five years ago earnings puffery popped out of a Cendant division. The stock imploded. Cendant has cleaned up its house and is operating well. It is strong in travel and real estate brokerage businesses. Vertical integration allows it to use its agents to market its array of consumer brands including Avis and Budget in rental cars, Ramada, Days Inn, Super 8 and Howard Johnson covering hotel pricing ranges, and Century 21, Coldwell Banker and ERA in real estate sales. The two businesses are complementary because usually, when one recedes, the other surges forward. With a 7.7% earnings yield, it's cheap.

I recommended **Constellation Brands** in July 2003. While up 50%, it still has room to run and remains cheap. It is the world's largest wine producer, concentrating on the lower-priced wines, which is where the growth is. It also sports an array of branded beers and spirits such as Black Velvet and Corona. Its real forte is distribution where it is the king of the liquor business. At 14 times this year's earnings, its earnings yield is 7.1%.

Cal-Maine Food is the US's largest producer of fresh eggs. It's modern, vertically-



integrated and highly automated operations give it a cost advantage over other majors. It owns 27 million birds and distributes to most major supermarkets. Yet not one material qualitative investment house covers this stock. It's virtually unknown! Its earnings yield is 25%. But be careful for two reasons. First, egg prices are volatile and I expect them to fall next year, reducing earnings, but not enough for this stock not to still be cheap with a very nice future earnings yield. Second, the stock trades thinly so trading must be patient.

Finally, **United Utilities** appeals as cheap and well-run. While Britain's largest operator of water and sewer systems – and electricity in the northwest – it also operates in Eastern Europe, the Far East and North America. With a current earnings yield of 9.6% backed by a dividend yield of 7.8%, the bird in the hand requires little else to justify ownership relative to what you could get from bonds.

ken@fisherinvestments.co.uk